The Potential Effects of IFRS for SMEs on New Zealand SME Financial Reporting

Research by: Maria Morunga

Supervisor: Professor Michael Bradbury

School of Accountancy, Massey University

Student ID: 02196379

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1. INTRODUCTION

In July 2009 the International Accounting Standards Board (IASB) released a new accounting standard called the International Financial Reporting Standard for Small and Medium-Sized Entities, or IFRS for SMEs (hereafter: IFRS-SME). It is intended for entities that publish General Purpose Financial Reports (GPFR), that are not large (to be decided by the standard setters of each country that adopts the standard) and are not "publicly accountable" - defined as not issuing public securities, and not holding funds in a fiduciary capacity for a wide group of people (IASB, 2009).

The standard was created as an alternative to the full IFRS suite, which was created for the financial reporting of large, publicly accountable entities. It was produced from IFRS by removing some topics considered irrelevant to SMEs, and by reducing the accounting options available for reporting some items. There is opposition to this manner of creation, because the users and user needs of SME reports may be different to those of large, publicly accountable entities' accounts, meaning that a standard created from full IFRS may have only limited relevance to SMEs.

New Zealand (NZ) adopted IFRS for large entities in 2007. There are currently two other tiers of GPFR in NZ, differential reporting (hereafter: DIFFREP), which contains exceptions for entities that are not large or publicly accountable. The third tier is especially for very small entities. Entities in the second and third tiers can choose to report using the reporting standards of the tier or tiers above them.

In NZ the second tier, DIFFREP, has been available for use since 1994. When NZ adopted IFRS, in 2007, the DIFFREP system was not updated, a review was postponed. In 2009 the NZ government and accounting standard setters started the process of reviewing the current DIFFREP system. IFRS-SME is a possible alternative to the current system, given that NZ has already adopted IFRS. NZ accounting standard setters have considered IFRS-SME as an alternative, but have made no decision to adopt. It is the aim of this study to give some empirical evidence and data to inform standard setters in their choice.

Areas of IFRS-SME that will potentially affect the size of SME reports, the cost of production of SME reports, and/or the financial results and solvency of SMEs are investigated. These are identified as:

(1) The requirement to prepare a statement of cash flows. It was found that this will increase the size of the reports created by the sample entities. This is likely to increase the cost of compilation of reports, but has limited value to users because of its historical nature. The cost is likely to exceed the benefit.

(2) The requirement to recognise and disclose deferred tax assets and liabilities. This is likely to have a significant effect on entities with fixed assets, who will be required to account for these differently under accounting and tax regulations, increasing the cost of preparation and the amount of information in the reports. There is research that has shown that reporting deferred taxes can improve the prediction of future cash flows for entities, but further research would be needed to verify whether that benefit outweighs the cost of disclosure. Also, anecdotal evidence from NZ standard setters is that most entities reporting deferred taxes are not doing this correctly, indicating the level of difficulty in accurately reporting deferred tax, increasing the cost of accounting.

(3) The requirement to amortise goodwill over 10 years. This was found to have a significant effect on the net assets of a SME if fully amortised, however the effect on total assets and total income of amortisation of 10% of goodwill was not found to be material for the sample.

(4) The option to report equity in the statement of comprehensive income. This has the potential to reduce the size of reports overall, which may be beneficial to users.

The next section gives a review of the literature on SMEs, SME financial report users, and IFRS-SMEs. In section three the research questions are developed. The methodology and data are explained in section four. Section five gives the analysis and results of the data, after which the conclusions are explained in section six.

2. LITERATURE REVIEW

Published academic articles and empirical studies of SMEs cover a diverse range of topics. Although authors note that academics have had difficulty researching SMEs for a lack of information (Yigui & Shumin, 2010; Evans et al., 2005; Collis et al., 2001). This review focuses on the issues related to financial reporting by SMEs. First, the economic significance of SMEs is reviewed. The review then looks at differential reporting for SMEs. Next, studies investigating the users of SME financial reports and their needs are reviewed. Finally, the relevance of certain accounting topics to SMEs and the relevance of the new IFRS-SME standards have been studied to some extent by various academics. Their findings and opinions are included in the review.

2.1 SME Economic Significance

SMEs represent over 90% of manufacturing enterprises worldwide (Morris & Brennan, 2000). They comprise 97% of US firms, and 96% of non-agricultural businesses in Australia (Jagoda & Herath, 2010). Yigui & Shumin (2010) estimate that SMEs account for two thirds of all employment in Europe. And Nerudova & Bohusova (2008) state that just 0.2% of companies in the European Union are considered large, which means that over 99% are SMEs.

In NZ 220 thousand of all 260 thousand NZ enterprises were found to be SMEs employing 5 or fewer staff (MED, 2002). Statistics show that 90% of NZ enterprises are SMEs (NZICA, 2010). This is a significant sector both in NZ and worldwide.

The NZ Ministry of Economic Development found that there was "little empirical literature on the qualitative profile of SMEs in NZ, but that research to date indicated that typical SME characteristics were: they were owner managed; had limited internal resources; high trade debt; had high gearing ratios; and were more reliant on short term loans and less reliant on shareholder interests (2002).

According to Liu and Yu (2008) SMEs have limited access to capital due to less stringent financial reporting requirements. This creates greater risks for lenders and investors in SMEs, which suggests that the existence of a financial reporting regime for SMEs benefits them by reducing the cost of obtaining finance and/or investor equity. Studies have shown that the major reason that small firms fail is poor financial management and reporting (Berryman, 1983). So it is important for SMEs to have some form of financial reporting. The question then becomes "which reporting regime should SMEs use"?

2.2 Differential Reporting

The reasons given for maintaining an alternative reporting or "differential reporting" framework (DIFFREP) for SMEs are usually taken from broad assumptions about the costs and benefits of compliance with full accounting standards. It is assumed that the costs of full compliance for SMEs outweigh the benefits.

Evans et al., (2005) discuss prior research on DIFFREP and explain that there are arguments for and against DIFFREP. Those that argue for a DIFFREP regime consider that there are undue burdens and costs of full reporting, which outweigh its benefits. The argument against a DIFFREP system is that there is a need for universality of reporting.

New Zealand adopted DIFFREP in 1994. It was created to deal with the cost-benefit issue of reporting for smaller private entities (Dale et al., 1992). NZ DIFFREP was created based on cost-benefit considerations and the limited applicability of financial reporting standards to SMEs (Dale et al., 1992). When NZ adopted New Zealand equivalents to International Financial Reporting Standards (NZ IFRS) in 2007 it was decided to retain the current DIFFREP framework. No review of the framework was undertaken at that time (NZICA, 2007).

Australia, the United Kingdom (UK) and Canada also have forms of DIFFREP for SMEs. South Africa did not have a DIFFREP regime until recently, but SMEs may now use IFRS-SME as an alternative to full IFRS reporting (Cohn, 2009). From their UK research Collis et al., (2001) concluded that a DIFFREP regime should be created not simply to reduce the cost of producing financial reports, but should be created with the aim of creating reports that are more useful to the users of those reports.

2.3 SME Financial Report Users and User Needs

When the Exposure Draft (ED) of the DIFFREP regime for Australia was released the majority of respondents to the ED were public accountants or preparers of the reports (Holmes et al., 1991). There were only a few respondents identified as possible financial report users (1991), suggesting that users rely on public accountants to represent them in responding to accounting standard changes. Holmes et al., (1991) surveyed a sample of accountants on their opinion of the need for a DIFFREP system in Australia at the time (1991). Respondents answered that DIFFREP was considered desirable for smaller entities. However, it is possible that their study failed to address the concerns of financial report users, because they reviewed only the opinion of preparers, who may have a vested interest in minimising the reporting and disclosure requirements for SMEs.

IFRS-SME was developed because the IASB recognised that SME financial report users differ from those of large entities and that their needs are different. The IASB lists the main users of SME financial reports as:

- Banks
- Vendors
- Credit rating agencies
- Customers, and
- Non-manager shareholders (IASB, 2009 para BC35).

However, there does not appear to be any empirical research done by the IASB to verify the users of SME financial reports.

It is noted that there are a limited number of empirical studies investigating SME financial report users and their needs (Collis et al., 2001; Evans et al., 2005). Evans et al., (2005) reviewed various empirical studies of SME users and user needs and identified the main user groups as:

- Banks/lenders
- Tax authorities
- Employees
- Managers, and
- Creditors.

This agrees to some extent with the users as stated by the IASB, but the list is not identical.

A UK study by Collis (2008) surveyed company directors and found that the main users of SME financial reports were:

- Banks/lenders
- Tax authorities, and
- Creditors.

The findings reaffirm user groups identified in Evans et al., (2005) and to some extent with users cited by the IASB. However, this study is limited by its low response rate (14%).

In another UK based study Collis et al., (2001) tried to identify users and user needs. Their questionnaire survey had a 45% response rate. They questioned company directors regarding users of SME company financial accounts. Again, similar to the above study results, the main users were identified as:

- Bank Managers
- Directors/Management
- Major Lenders
- Customers, and
- Tax authorities.

They conclude that any attempt to create specific standards for SMEs should aim to create standards that improve usefulness of accounts for users. The limitation of this study is, again, that company directors were questioned. Company directors may not have as full an understanding of accounting, nor recognise all users of SME financial reports.

Canada has introduced a set of DIFFREP standards for SMEs. Rennie and Senkow (2009) analysed the response letters to the Canadian DIFFREP Exposure Draft (ED). Their study also produced evidence that lenders are the main users of SME financial accounts.

In their study the response regarding implementation of a special set of DIFFREP reporting standards for SMEs was overall positive. There was only one response from a “user” of SME financial accounts. He was classed as an investor. That respondent disapproved of special accounting standards for SMEs because it reduced comparability.

This single response suggests that the attempts of empirical research to identify user needs may be failing to recognise true user needs, if research is based on company directors’ and accountants’ opinions of DIFFREP and SME reporting, the overall response being favourable to DIFFREP. Suggesting that more investigation of actual users is needed.

Maingot and Zeghal (2006) created a questionnaire survey on SME reporting in Canada. Their questionnaire was directed toward SME account preparers (i.e., accountants). The results agree with other surveys that identify the main SME financial report users as

- Banks/Lenders
- Tax authorities, and
- Internal Management.

Extrapolating from their questionnaire responses, they conclude that users of SME financial reports prefer one set of GAAP with exemptions for SMEs because full GAAP is:

- Time-consuming
- Too complex
- Too costly, and
- Lacks relevance.

Again, the responses to the questionnaire are from preparers of SME financial accounts (accountants) not from the users themselves. This is a major limitation of the study. Accountants may believe that full GAAP is time-consuming, costly, etc. However, this does not address the information needs of users, rather the cost concerns of preparers.

The study once again highlights the point that the literature on SME financial report users and user needs is lacking investigation of actual users and what their needs are. Researchers sampling preparers and internal management (e.g., Directors) as proxies for users are not answering the question "What do users want from SME financial reports?"

A US study by de Mesa Graziano (2006) used surveys and limited interviews of financial account preparers and bankers of SMEs (bankers were used as proxy for SME account users). The results showed that the majority of bankers in the survey wanted audited full GAAP compliant accounts. This was because these reports are considered more accurate and to have a higher degree of comparability. This potentially indicates that the main users of SME financial accounts, as identified in numerous other empirical studies (i.e., bankers), do not want a different set of standards applicable to SMEs other than full GAAP. That they disapprove of DIFFREP. However, where banks lend to SMEs they can demand a higher volume of information than is required in general purpose financial reports. As such they are not true general purpose users.

That finding does, however, agree with the response to the Canadian DIFFREP ED from the only SME account user respondent. As noted above, he responded negatively to the Canadian DIFFREP ED because he considered that DIFFREP would reduce comparability (Rennie & Senkow, 2009). So it appears that more investigation into users needs is needed.

de Mesa Graziano (2006) also found that users are more interested in operating data, for example cash flows. This is an interesting finding, and is relevant to IFRS-SME. IFRS-SME requires entities reporting under IFRS-SME to prepare a cash flow statement and reconciliation (IASB, 2009). de Mesa Graziano's finding suggests that requiring a cash flow statement may be relevant to user needs. However, comment from a member of the NZ

ASRB is that it is future cash flow information which is informative to users, that past cash flows are not relevant, and are a cost.

Riistama & Vehmanen (2004) identified the following as user needs:

- Profitability
- Solvency
- Prior Year Events, and
- Future Prospects.

Company directors, in a study by Collis (2008), were also asked to consider the use of IFRS-SME. The results showed that respondents believed IFRS-SME would be advantageous if it increased international comparability of SME financial reports. The study's limitation was using company directors to investigate the usefulness of financial reports prepared under IFRS-SME, as directors are not actual users of the accounts.

Discussion of SME reporting standards is ongoing in the US. Cheney (2010) comments that a panel consisting of members from various US accounting bodies will be considering the topic in general and IFRS-SME in particular. They will focus on users and user needs in their considerations. Once again showing that standard setters are conscious of users and user needs. It is imperative that better investigation of user needs be undertaken in countries now using DIFFREP regimes and those countries considering adopting IFRS-SME (including NZ).

According to Pacter, the IASB based IFRS-SME on user needs that they considered important:

- Short term cash flows
- Liquidity, and
- Solvency (Pacter, 2009).

They omitted accounting issues that they did not consider relevant to SMEs:

- Earnings per share
- Interim financial reporting
- Segment reporting
- Reporting in a hyperinflationary environment
- Agricultural assets
- Share-based payments

- Extractive industries
- Reporting as a lessor in a finance lease, and
- Insurance contracts.

They decided to include fewer accounting options in IFRS-SME, and to require fewer disclosures, they also simplified several areas of reporting (IASB, 2009b; Pacter, 2009). However, there is no supporting evidence given for their decisions.

Another reason given for creating IFRS-SME was to increase the comparability of SME accounts across borders. Nerudova & Bohusova (2008) found that Czech SMEs considered international comparability important. Comparability was considered especially relevant for entities that engaged in cross-border transactions.

They found that users of SME financial reports had a greater interest in

- Short term cash flows
- Liquidity
- Balance Sheet strength, and
- Interest cover.

These qualities, as well as those identified in other studies, should therefore be highlighted in any set of SME financial reporting standards.

As noted previously, the de Mesa Graziano study found that users were more interested in operating data (de Mesa Graziano, 2006).

Adela & Silvia (2009) analysed the comment letters received by the IASB in response to the IFRS-SME exposure draft. They took a sample of the responses and investigated "stakeholder needs". A limitation of this study is that most comment letters are from account preparers or standard setting bodies, with just a few being from academics. These were the stakeholder groups represented in the sample. They found that respondents:

- preferred historical cost to fair value accounting
- were more concerned with long-term viability of an entity
- thought that short term cash flow information is important
- believed profitability to be important
- wanted accounting options to be limited, and
- wanted limits put on the information to be disclosed.

The limitation with this study is that the information is not being gathered from actual users of the accounts, but from respondents to the ED, a group of mainly accountants and standard setters. However, there is some overlap with findings of other studies on what information users want from SME reports, such as cash flows.

From this limited pool of users and user needs evidence in the literature it appears that users value the following information (at least) in SME financial reports:

- Operating data
- Cash Flow information
- International comparability
- Profitability
- Solvency
- Liquidity
- Balance sheet strength
- Interest cover
- Prior year events, and
- Future Prospects.

Other user needs and topics considered irrelevant by the IASB, as listed in the discussion above, should be investigated in terms of actual users and their needs.

Further consideration of IFRS-SME and its suitability for SME reporting is given in the next section.

2.4 Applicability and Relevance of IFRS-SME

The expected benefits of IFRS-SME are international acceptance of financial reports created using IFRS or IFRS-SME; international comparability of SME financial reports; and understanding by users of the reports world-wide (NZICA, 2007). Also, there is expected to be a cost saving on the standard setting process for adopting countries (IASB, 2009b).

Some countries adopted IFRS-SME as soon as it was released. One example is South Africa. The reason for its adoption was the legislative requirement that all limited liability companies prepare financial accounts using IFRS. Prior to the release of IFRS-SME all such entities, regardless of size, were required to prepare their financial accounts fully compliant with IFRS. This was considered too burdensome, and as such, the government now allows SMEs to report under the new standard (Cohn, 2010).

Haller and Eierle (2004) point out that many countries' SMEs would have to adopt full IFRS, due to World Bank demands. Where there is no DIFFREP system in a country IFRS-SME may be a cost effective alternative to full IFRS.

Research in Bahrain, by Joshi & Ramadhan (2002) showed evidence that SMEs who chose to report under IFRS (IFRS-SME was not available at the time) found it easier to get loans from banks. They also found it helpful for audit purposes. The study also revealed that IFRS reporting was aiding Bahrain SMEs that reported under full IFRS to better control financial management. The introduction of IFRS-SME to these companies may reduce their compliance costs, but at the same time maintain the relative ease of obtaining bank finance, due to international recognition of the IFRS-SME standard and the standard's perceived value.

Other countries have not been so quick to adopt the standard, including New Zealand and Australia. These countries' standard setters are treading more cautiously in their consideration of the appropriateness of the new standard and its adoption. The ASRB states in its discussion document that "the differing measurement and extensive disclosure requirements of IFRS-SME means that its suitability for use as a differential version of IFRS is still being assessed in Australia and NZ" (ASRB, 2009). This study hopes to inform standard setters in NZ as to the potential effects on financial reporting that IFRS-SME may have for NZ SMEs.

The Evans et al (2005) review of SME literature found evidence that there is no need for international comparability of SME financial reports. And that the standard has no relevance to reporting for tax purposes. In countries whose current reporting standards are aligned with tax reporting requirements, this would create a need for additional tax purpose reporting. The additional requirement would increase the cost of financial reporting for SMEs in adopting countries where accounting standards are aligned with tax reporting.

In contrast to this, when the Australian DIFFREP ED was released, Holmes et al., (1991) found that accountants were using the tax basis for preparing financial reports. But that they did not agree with accounting standards being developed based on tax rules or legislation. So, in that case, a distinction between reporting for tax purposes and financial reporting appears to have been preferred.

Evans et al., (2005) concluded that the IASB should develop IFRS-SME, but that they should not base the standard on the full IFRS framework, which was developed for public companies, and is not appropriate for SMEs. The standards should, instead, be based on user needs. Other academics share this view (Nerudova & Bohusova, 2008). The IASB did not take this recommendation into account when creating the IFRS-SME. It is based on full IFRS and the IFRS framework (Pacter, 2009).

European Union research considering IFRS-SME has been published. Eierle & Haller (2009) reported on their questionnaire study conducted in Germany. The questionnaire asked company directors whether they thought international comparability was needed for SME financial reports. Around half of the respondents didn't think this was important, despite the majority of the respondents stating that importing and exporting were important for their business.

The study also asked what accounting topics were important for SMEs. They found that the following were considered important:

- Research and Development
- Construction Contracts
- Business combinations
- Goodwill accounting, and
- Acquisitions.

Topics considered unimportant were:

- Lessor in a finance lease
- Share-based payments
- Sale of business units
- Discontinued Operations
- Hedge accounting, and
- Investments in listed companies.

Their results also show that there were higher costs considered for fair value accounting for Plant, Property and Equipment. Greater benefits were assumed for deferred tax reporting and percentage of completion accounting for construction contracts. However, respondents were concerned that the cost of these accounting methods may be higher than the current accounting methods. Overall, the study found mixed applicability of IFRS-SME in Germany (2009).

Joshi & Ramadhan (2002) found that Bahrain SMEs always prepared Balance Sheets, but only prepared Income Statements and Cash Flow Statements 90% and 71% of the time, respectively. Their results show that those SMEs reporting under full IFRS always used the following when preparing financial reports:

- Depreciation Accounting
- Presentation of current assets and liabilities, and
- Inventories.

And that SMEs often, but not always, reported on the following:

- Cash Flow Statement
- Property, plant and equipment
- Revenue recognition
- Related parties
- Contingencies, and
- Events after balance date.

Which suggests that these topics were relevant to SMEs in the study. However, employee benefits and other standards from the IFRS suite were not used (2002).

The IASB listed the simplifications and omissions in IFRS-SME compared with full IFRS as noted in the discussion above (IASB, 2009b). IFRS-SME retains the requirement to prepare a cash flow statement. Reporting changes in equity can be combined with the statement of comprehensive income if the profit or loss is the only change in equity for the period.

Though there is no evidence of the benefit to users of goodwill amortisation, IFRS-SME requires that goodwill (and other indefinite life intangibles) be amortised over 10 years (IASB, 2009a).

The European Financial Reporting Advisory Group (EFRAG) (2010) analysed IFRS-SME against the European Union Accounting Directives. They found several potential differences:

- IFRS-SME prohibition of Extraordinary Items of income or expense

- Amortisation of goodwill over 10 years in IFRS-SME (none in Europe)
- Negative goodwill being recognised immediately in profit and loss
- Amounts receivable from equity instruments to offset equity – not treated as an asset, and
- No reversal of goodwill impairment permitted.

At the time of the release of this information EFRAG was still undecided as to whether IFRS-SME was acceptable for the financial reporting of European SMEs. These differences are similar to those between current NZ differential reporting standards and IFRS-SME.

The comparison of IFRS-SME and UK financial reporting in Topazio (2009) found similar differences, being:

- Amortisation of Goodwill over 10 years
- Accounting for business combinations
- Cash flow statement
- Deferred tax
- Accounting for financial instruments
- No segment reporting, and
- No earnings per share.

Another European study of SMEs, from the Czech Republic, recognises that there is limited integration of SMEs into the EU single European Market. It is therefore questionable whether harmonisation of SME financial reporting is really necessary (Mullerova et al., 2010). The issues that appear to hinder integration into the European Market include different legal and tax systems, limited access to capital and finance, cultural and language barriers, and limited support of SMEs in the market.

Mullerova et al., (2010) also believe that the apparent convergence of IFRS-SME with US GAAP may be destructive to European accounting values. However, they agree that where there are foreign investors in an SME, or the SME is part of a consolidated group, that IFRS-SME may have a place in European SME financial reporting. However, the responses to their questionnaire indicate that SMEs in the Czech Republic do not expect any benefit from using IFRS-SME, and that they do not anticipate using the standard in the future. This is apparently due to the higher expected cost of reporting under IFRS-SME.

The limited perceived need for international harmonisation of SME financial reports is relevant to NZ. Unlike Europe (or the Americas, Asia & Africa), NZ does not border other countries. Our closest economic ties are with Australia. For many NZ SMEs there would be little need for international comparability of financial reports, though there could be benefits to having financial reporting standards that are comparable to those in Australia. The NZ Ministry of Economic Development and New Zealand Accounting Standards Review Board (ASRB) recognise the importance of comparability with Australia, and are bearing this in mind in their review of the SME financial reporting regime in NZ (MED, 2009; ASRB, 2009).

Adela & Silvia (2009) investigated "whether and in what conditions fair value usage is appropriate for SMEs?" They undertook a content analysis of the comment letters that the IASB received in response to the IFRS-SME ED. The comment letters were given scores for not applicable, partial approval, or complete approval of fair value usage for SME financial reporting.

Their main finding was that respondents were in favour of use of fair value rather than rejecting it, but that it should not be the default measurement basis. Respondents also requested the insertion of the "value in use" valuation method (which was omitted from the ED). Adela & Silvia (2009) voice concern that the IFRS-SME has been influenced by US standards and standard setters, and that this has increased the focus on market value over historical cost. However, market value is often impractical for SMEs.

2.5 Literature Review Summary

SMEs make up a significant proportion of NZ businesses. Differential reporting has been adopted in NZ for the financial reporting of these entities. This is supposed to improve the cost-benefit ratio for SME reporting. The development, or choice of, a DIFFREP system should be based on the users of SME reports and their needs. The main users identified are banks, creditors, tax authorities, and managers.

Numerous user needs are identified in the literature. Those that correspond to, or appear contrary to, reporting requirements under IFRS-SME are used in the next section to develop the research questions of this study.

3. DEVELOPING THE RESEARCH QUESTIONS

If we are to accept what standard-setters and some researchers tell us, then a DIFFREP system is beneficial for reducing the cost of financial reporting, though this should not come at the cost of the quality of information made available to SME financial report users. It is therefore important to weigh user needs when considering the value of a DIFFREP system. The system should be informative, the benefits of producing the information should outweigh the costs, and there should be a limit to the amount of information, so as to avoid information overload for users.

As such this study will analyse IFRS-SME as a potential DIFFREP standard for New Zealand, in terms of the user needs identified in the literature (despite the limitations of those findings). Because NZ already has a DIFFREP system in place, the analysis will compare IFRS-SME to the current NZ DIFFREP system.

The literature identified various user needs for financial reports. First there are needs which are not DIFFREP or IFRS-SME specific. Profitability, solvency, liquidity, and balance sheet strength were identified as user needs. This information can be gleaned from financial accounts including an Income Statement and a Balance Sheet. Full NZ IFRS, NZ DIFFREP, and IFRS-SME all require these two statements. As such there is nothing to compare in terms of the differences in reporting regimes. No testing related to these needs is done here.

It was found that users also want information regarding the future prospects of an entity, prior year events, and international comparability of financial reports. The first two factors cannot be measured from financial reports alone. The third is an all or nothing characteristic, dependant upon the reporting system in place in a country. If the country has adopted an international set of reporting standards then a resident entity’s financial reports will be internationally comparable. Therefore these factors do not lend themselves to measurement in terms of differences between current NZ DIFFREP and IFRS-SME adoption. This study does not test these needs.

Prior research also indicates that users have preferences for SME financial reporting system characteristics: (1) that they limit accounting options, and; (2) that they limit disclosure requirements. The literature confirms that in creating IFRS-SME the IASB limited both accounting options and disclosure requirements as compared to full IFRS. This is not the case when IFRS-SME is compared to NZ DIFFREP. IFRS-SME has more disclosure requirements than NZ DIFFREP. Examples include the requirement to account for and have full note disclosure of financial instruments; to prepare a statement of cash flows; to account for deferred taxes. Commentary on the IFRS-SME compared to NZ DIFFREP concludes that there are more disclosures required in IFRS-SME. That reporting system is therefore not consistent with regard to users' preference for limiting disclosures.

Research has found that the specific accounting disclosures valued by users include cash flow information and deferred tax recognition, although these appear to contradict the user preference for fewer disclosure requirements. The inclusion of deferred tax assets and liabilities for large companies adopting IFRS in NZ was found to significantly increase total liabilities more than assets, suggesting that there will be an expected overall increase in liabilities where deferred tax accounting is introduced to SME reporting (Stent et al., 2010). This would reduce the net assets and solvency of entities. The inclusion of this tax allocation has been found to improve the prediction of future cash flows (Cheung et al., 1997). So there are potential costs and benefits of adopting deferred tax accounting.

IFRS-SME differs from NZ DIFFREP in that it requires entities to prepare a statement of cash flows. Also, it requires entities to recognise deferred tax assets and liabilities. It also requires goodwill to be amortised over 10 years. These are all potential additional disclosures which could increase the cost of preparing financial statements and increase the potential for information overload on the account users.

There is one potential reduction to reporting content that IFRS-SME has over NZ DIFFREP. When the only change in equity for the reporting period is the profit or loss there is no requirement to prepare a separate statement of movements in equity. The movement can be reported in the statement of comprehensive income.

Research questions taken from the above discussion are:

RQ 1. *Will the requirement in IFRS-SME to prepare a statement of cash flows increase the financial reporting disclosures for NZ SMEs when compared to reports prepared under NZ DIFFREP?*

RQ 2. *Will the IFRS-SME requirement to recognise and disclose deferred tax assets and liabilities increase the financial reporting disclosures for NZ SMEs when compared to reports prepared under NZ DIFFREP?*

RQ 3. *Will the IFRS-SME requirement to amortise goodwill over 10 years have a significant effect on SME reporting when compared to reports prepared under NZ DIFFREP?*

RQ 4. *Will the IFRS-SME option to report equity in the statement of comprehensive income have the potential to decrease financial report size when compared to reports prepared under NZ DIFFREP?*

4. RESEARCH METHODOLOGY

4.1 Sample Selection

In NZ there is a statutory requirement for limited liability companies to prepare financial statements. There are certain criteria whereby SME companies must (at least) report under DIFFREP. It is also possible for SME companies that are not required to use NZ DIFFREP to opt to report under NZ DIFFREP. No distinction between the two was made in the sample choice.

The sample was chosen from the client list of a mid-sized accounting firm based in a rural NZ centre. The firm provides services to a large number of clients, a large proportion of which are SME companies. Company names were chosen at random from a list of company clients. Where the company chosen reported using NZ DIFFREP in 2009, it was included in the sample. Where the company did not use NZ DIFFREP it was missed, and the next company name in alphabetical sequence was chosen.

A total of 42 companies were chosen to make up the sample. The financial accounts for the financial year 2009 were acquired for each of the sample companies.

4.2 Data Collection

The 2009 financial accounts of the sample companies were used to collect information about the entity in general:

The type of business activity the company is involved in; the total annual income for 2009, and; the number of shareholders.

Information relating to the research questions was also collected from the 2009 annual reports.

To address RQ 1 the annual reports were viewed to record either the presence or absence of a cash flow statement. The absence of this report in 2009 would indicate that reporting for that entity under IFRS-SME would require additional disclosure of a cash flow statement and the corresponding reconciliation.

To address RQ 2 the balance sheet was viewed to record the presence or absence of either deferred tax assets or liabilities. To assess the likelihood that the entity would need to report either deferred tax assets or liabilities in the balance sheet, if it reported under IFRS-SME, the presence of fixed assets in the balance sheet was recorded. The most common deferred tax adjustments are those required due to differences in the accounting and tax bases of fixed assets. As such the presence of fixed assets indicates a likelihood that the entity would have additional reporting requirements under IFRS-SME, as IFRS-SME requires entities to account for deferred tax. The existence of tax losses brought forward (which would result in a deferred tax asset) was unable to be ascertained for this exercise via review of financial statements, but is a potential avenue of further research into their effect on the balance sheet.

To address RQ 3 the presence or absence of goodwill in the balance sheet was recorded. For those entities that did have a goodwill asset, the amount of goodwill was recorded, as well as the total and net assets. Further analysis is described in section five.

To address RQ 4 the statement of changes in equity was assessed for the presence of any movement other than the profit or loss for the year. The absence of additional items would allow entities reporting under IFRS-SME to eliminate the statement of changes in equity, and combine the reporting of changes in equity in a single statement of comprehensive income. This could potentially reduce the volume of the financial report.

5. ANALYSIS

5.1 Sample Descriptive Statistics

The sample includes companies engaged in a variety of business activities. Table 1 shows that 19% were agricultural/horticultural/fishing companies, 17% property development, 17% retail, 14% contracting, 7% health care. The remaining 26% were engaged in other business activities. This variety of activity types means that the results of the study can be generalised to a wide range of NZ SMEs.

The number of shareholders per company was limited. As shown in table 2, 90% of the sample companies had 5 or fewer shareholders. The maximum number was 8 shareholders.

The mean annual income for the sample companies was $628,000, with a range of $0 to $10.6 million. Over 50% of sample companies had total annual income for 2009 of less than $1 million.

The low shareholding and income of companies in the sample appears inconsistent with the requirement to report under NZ DIFFREP. Companies which meet certain criteria are exempted from full reporting under the financial reporting order. However, the companies sampled have either chosen to report using DIFFREP, or are required to for some other reason. As such, the assumption is that the sampled companies would choose to continue to report under DIFFREP if IFRS-SME were adopted in NZ. Alternatively, if such companies found that IFRS-SME was too great a reporting burden they may opt for the exemption if they met the exemption criteria. This result cannot be known without adoption of IFRS-SME. However, the reaction of these firms to adoption of IFRS-SME is an avenue for future research.

5.2 Research Questions Answered

5.21 Cash flow statements

None of the sample companies prepared a cash flow statement. The implication of this finding is that the adoption of IFRS-SME would increase the required disclosures of NZ SMEs by requiring a cash flow statement and corresponding reconciliation. With increased disclosures and statements come increased compliance costs. However, as noted in the literature, cash flow information has been found to be of value to users. As such, further research on the relative cost for preparation of the cash flow statement will need to be done to evaluate whether that additional cost is offset by an equal or greater increase in the benefit of accounts to users.

For the purposes of this study it is sufficient to conclude that our results show there will be an increase in disclosure requirements for NZ SMEs.

5.22 Deferred tax

None of the sample companies reported deferred tax assets or liabilities in 2009. However, 81% of the sample reported fixed assets in the Balance Sheet. The implication is that companies reporting fixed assets have potential to generate deferred tax assets or liabilities if they account for their fixed assets as required by IFRS-SME. This will result in assets being reported differently for NZ tax purposes. As IFRS-SME is not a NZ specific reporting standard a difference is expected between the accounting base of fixed assets and the tax base of those assets.

As the majority of sample companies held fixed assets at balance date, we can conclude that adoption of IFRS-SME would increase the disclosure requirements for most NZ SMEs to include deferred tax. This would increase the compliance costs for companies. However, as with cash flow information, the literature has found that users may value deferred tax information, though this is dependent upon the cost of the information not being greater than the additional value of the information. The value of deferred tax information would need to be researched before an opinion on whether it is beneficial (outweighing the cost of information disclosure) could be formed.

5.23 Amortisation of goodwill

24% of sample companies had a goodwill asset in the Balance Sheet. The value of the goodwill ranged from $10,000 to $1.05 million. The significance of the goodwill to the company was indicated by showing:

a) 10% of goodwill as a percentage of the net assets
b) 10% of goodwill as a percentage of the total income
c) Total goodwill as a percentage of total assets

The results of (a) range from -83% to 12% (the negative value of results is representative of the negative net asset value). The median is 1.1% (see table 4, column 3). If we consider this as the effect on the Balance Sheet of goodwill amortisation for 1 year, it does not appear to have a significant effect. Significance in terms of users is often described as materiality. Comparing the median of 1.1% to an asset materiality of say 10%, there appears to be no significant, i.e. material, effect on the balance sheet.

Table five shows the number of companies with changes of 0%, 0 to 5%, 5 to 10%, and over 10%, where a change of 5% or over is considered material. For test (a) table 5, column 3 shows that only 4 of the 10 companies with goodwill in their balance sheets show a material change of 5% or more in net assets when 10% of goodwill is amortised. This suggests that this change in reporting standard would not have a material effect on net assets for the majority of companies.

The results of test (b) range from 0% to 7.4%. The median is 0.6% (see table 4, column 2). This test indicates what effect the amortisation of goodwill would have on the Income Statement. According to these results the amortisation expense for the year would not have a significant effect on the Income Statement, on average (The median of 0.6% being so small proportion of the total income that it is not considered material). However, the individual results of sample companies where the results are higher, e.g. the maximum of 7.4%, suggests that goodwill amortisation, as required by IFRS-SME may have a significant effect on some companies' reported profits.

The materiality results of this test, as shown in table 5, column 2, confirm that the majority of companies do not show a materially significant change in total income with 10% amortisation of goodwill.

The results of (c) range from 0.7% to 67.6%. The median is 11.6% (see table 4, column 4). The median for the sample is greater than 10%, suggesting that overall there is a material change in total assets with the complete amortisation of goodwill. This is confirmed in table five, column 4, which shows that 6 of the 10 sample companies with a goodwill asset would show a materially significant change if goodwill were fully amortised.

5.24 Need for a statement of movements in equity

Of the sample companies, 38% had additional movements in equity apart from the profit or loss for the year, meaning that those companies would not be able to benefit from a reduction in reporting by including equity movements in a single statement of comprehensive income. This is a large proportion of the total sample, and thus it would appear that there is no general benefit to be gained from this reduction in reporting.

5.3 Research Limitations

The sample size is small, and may not be representative of the larger population of NZ SMEs. Also, the sample is taken from rural enterprise, and again may not be representative of NZ SMEs.

Apart from measures of materiality, statistical analyses of the results have not been performed. This is a possible avenue of further analysis in this area.

There are other differences between current NZ DIFFREP and IFRS-SME. These have not been investigated here. This leaves further areas requiring investigation before a complete picture of the value of IFRS-SME in NZ can be assessed.

6. CONCLUSIONS

The literature on SME financial reporting has shown that it is important to consider users and user needs when creating a reporting system for these entities. The IFRS-SME has been created with some of these needs in mind, but it also contains other reporting requirements which may create more burdensome reporting in NZ than the current system.

The results of this study show that IFRS-SME requirement for a cash flow statement will create more accounting output requirements and potential costs for SMEs. There is debate about the value of historical cash flow information. Further study of the value of the cash flow statement to SME report users should be done before this requirement is imposed on SMEs.

The study found that the requirement to account for deferred taxes would have a significant effect on the amount of disclosure required by the sample companies. There is some evidence that deferred tax disclosure is beneficial to users, and that users value its disclosure, but the cost of disclosure may be greater than the benefit found. This is an avenue for further research.

Where goodwill is required to be amortised over 10 years this significantly affects total assets when 100% of goodwill is amortised. However, there is limited material effect for 10% amortisation on both net assets and total income. This suggests that 10% amortisation will not affect results annually, but when it is amortised in full (after 10 years) that will have a material effect on the total assets, and as a result, on equity and solvency.

The results show that a majority of sample companies could benefit from a reduction in report volume where a statement of changes in equity is not required. This would be beneficial in terms of reducing information overload for users.

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8. APPENDICES

Business Activity	
Ag/Hort/Fishing	19%
Property Development/management	17%
Retail/Services	17%
Contracting	14%
Healthcare	7%
Other	26%

Table 1. Business segment analysis of sample

Number of Shareholders	
1	38%
2	24%
3	21%
4	5%
5	2%
6	5%
8	5%
Min	1
Max	8
Median	2

Table 2. Number of shareholders of sample group

Total Annual Income	
<$500k	43%
$500k<x<$1mil	14%
$1mil<x<$5mil	36%
$5mil<x<$10mil	2%
$10mil +	5%
Min	$0
Max	$10,613,000
Median	$628,000

Table 3. Total income for sample group in 2009

	10% Goodwill as % of Income	10% Goodwill as % of Net Assets	Total Goodwill as % of Total Assets
Mean	2.42	-5.56	18.60
Median	0.55	1.14	11.60
Min	0.02	-83.70	0.70
Max	7.38	12.18	67.55

Table 4. Percentage change in income and net assets with amortisation of 10% goodwill. Percentage change in total assets with 100% amortisation of goodwill.

	10% Goodwill as % of Income	10% Goodwill as % of Net Assets	Total Goodwill as % of Total Assets
x =0%	0	0	0
0%< *x* >=5%	8	6	4
5% *x* >=10%	2	2	1
x >10%	0	2	5

Table 5. Number of sample companies with goodwill asset that show material change of greater than 5% or 10% in income, net assets, or total assets on amortisation of goodwill.

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Morunga, Maria

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